Case #1

MARKING GUIDE
OMEGA CORPORATION INC.
ASSESSMENT OPPORTUNITIES

To: Chad Bowie, VP Finance
From: CPA
Subject: Tax Implications of Real Estate Financing Reorganization

Assessment Opportunity #1

The candidate calculates the fair market value of the properties and recommends which groups of properties should be transferred to the new legal entity.

The candidate demonstrates competence in Finance

CPA Map Competencies:
5.1.2 – Develops or evaluates financial proposals and financing plans (Core – Level B)

5.2.3 – Evaluates sources of financing (Core – Level B)

Introduction

The purpose of this report is to summarize the necessary steps to transfer a portion of our real estate portfolio to a newly formed entity, RealCo, to facilitate the financing of a potential acquisition. You have indicated that we require at least $45 million.

Property Fair Market Values

I have calculated the fair market values (FMVs) of each property in Appendix I, including a split between land and building. The calculations were completed by applying the capitalization rate applied to the net operating income (NOI) of each property. The land fair market values were indicated as 30% of the total value, which resulted in the balance of the value of each property being attributed to the building.

Land Transfer Tax

Total land transfer tax on the move will be $1,988,000, as calculated in Appendix II.

Funds Available

After the calculations performed, I have determined that $62,418,000 will be available from the financing. This is after deducting the expense for the financing fees. Since we require only $45 million for the expansion, there is more than enough capacity for this transaction, even if we apply some of the proceeds towards paying the taxes on the transfer of the land inventory.

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Assessment Opportunity #2

The candidate explains a tax-deferred rollover.

The candidate demonstrates competence in Taxation

CPA Map Competencies:
6.1.5 – Analyzes the tax consequences or planning opportunities for complex corporate transactions (Core – Level C; moves to Level B in Taxation Elective)
6.1.6 – Describes the tax consequences of other corporate and partnership restructuring transactions (Taxation Elective – Level C)

Tax-Deferred Rollovers

A corporation may transfer assets to another corporation on a tax-deferred basis pursuant to subsection 85(1) of the Income Tax Act. These provisions allow an entity to defer the taxation of an asset with an accrued gain by transferring the asset to another entity in exchange for a combination of equity and non-equity consideration. The deferral of the tax is achieved through the movement of the accrued gain from the asset transfers to the equity instrument, which is received in exchange.

Once we determine which assets are “eligible property” (see below) as defined in subsection 85(1.1), we would transfer the properties to RealCo in exchange for a note payable equal to the elected amount and a single common share of RealCo for the balance of the consideration.

We will use a note payable to facilitate an efficient return of capital to OCI through the repayment of intercompany notes. This will be easier than completing a return of the legal paid-up capital and adjustment to the share structure.

We will select common shares because the company is a wholly owned subsidiary and there is no need to create a separate class of shares.

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Assessment Opportunity #3

The candidate discusses the transfer of the land inventory.

The candidate demonstrates competence in Taxation

CPA Map Competencies:
6.1.5 – Analyzes the tax consequences or planning opportunities for complex corporate transactions (Core – Level C; moves to Level B in Taxation Elective)
6.1.6 – Describes the tax consequences of other corporate and partnership restructuring transactions (Taxation Elective – Level C)

Transferring Land Inventory

Land inventory is not eligible for section 85 rollovers due to the definition of "eligible property" found in subsection 85(1.1) of the Income Tax Act. Identifying real property that may be considered inventory is, therefore, critical to the mechanics of a tax-deferred transfer. Specifically, the tax-deferred rollover would have been denied on Property II, resulting in taxes being payable on that property.

To determine whether the property would be considered inventory or capital for tax purposes, we need to look at a number of factors, as outlined by the CRA in archived bulletin IT-218R. It is unlikely that this property would be considered capital property because

- the property is listed as land inventory on the schedules provided (indicating management's intention);
- the property was only acquired this year and management is already considering a sale;
- OCI operates an electronics retailer business and the land is zoned as residential, suggesting OCI could not use it for its business even if it wanted to; and
- the only argument for capital treatment is that the intention at the time of purchase was for future business expansion at Property II, but the actions of management suggest the company is not following through on this intention.

All of these factors taken together indicate that the original purpose of the transaction was not to acquire capital property for use in the business but for resale. Therefore, it would not be appropriate to include the property on our section 85 transfer to RealCo.

As a result, the land inventory will result in income of $5,500 for OCI when it is transferred to RealCo.

Alternative

A corporation may also transfer assets to a partnership on a tax-deferred basis pursuant to subsection 97(2) of the Income Tax Act. Transferring assets to a corporation or a partnership uses the same mechanical provisions of the Income Tax Act found in section 85; however, land

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inventory may be transferred to a partnership under 97(2), whereas it may not be transferred to a corporation under 85(1). This restriction does not exist in subsection 97(2) because it does not make reference to the definition of “eligible property” that is in subsection 85(1.1) of the Income Tax Act.

Since the loan agreement allows for the possibility of transfer to any “corporation or partnership,” it may be possible to establish a partnership instead of a corporation to accomplish this goal.

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Assessment Opportunity #4

The candidate prepares the draft tax election form.

The candidate demonstrates competence in Taxation

CPA Map Competencies:
6.1.5 – Analyzes the tax consequences or planning opportunities for complex corporate transactions (Core – Level C; moves to Level B in Taxation Elective)

I have prepared, in draft, T2057 election forms to facilitate the transfer of the properties under section 85 of the Income Tax Act in Appendix III. This transfer will result in OCI receiving a promissory note in the amount of $65,200, plus one common share with a value of $11,800 and an ACB and paid-up capital of nil.

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Assessment Opportunity #5

The candidate advises on the elected amount, the property with a terminal loss, and the filing deadline.

The candidate demonstrates competence in Taxation

CPA Map Competencies:
6.1.5 – Analyzes the tax consequences or planning opportunities for complex corporate transactions (Core – Level C; moves to Level B in Taxation Elective)
6.1.1 – Assesses a corporate entity's general tax issues (Core – Level B; moves to level A in Taxation Elective)

Selecting the Elected Amount

The tax deferral is achieved through the selection of the elected amount, which is an agreed-upon amount between the vendor and the purchaser. The elected amount becomes the vendor's proceeds and the purchaser's cost. It should be noted that for depreciable property, the original capital cost of a property is inherited by the purchaser, in effect preserving any recapture that may result on a subsequent disposition of the property by the purchaser.

We are transferring both depreciable property (i.e., the building) and non-depreciable property (i.e., the land), each of which has slightly different rules. In both cases, the elected amount cannot be less than the amount of non-share consideration that is received from the acquirer, and it cannot be greater than the fair market value of the property at the time of transfer.

In addition, for depreciable property, the elected amount cannot be lower than the least of

- the undepreciated capital cost of all property of that class immediately before the disposition;
- the cost to the taxpayer of the property; and
- the fair market value of the property at the time of the disposition

As we are transferring real estate in multiple classes, care must be taken regarding the minimum elected amounts for depreciable property. These are outlined in more detail on the draft T2057 election form.

Property IV Terminal Loss

Since the building has a fair market value that is less than the undepreciated capital cost and the fair market value of the land is less than the cost of the land, there is no need to include this property on the section 85 election.

The sale of the property will give rise to a capital loss on the land of $1,000 ($4,000 FMV less $5,000 cost), which will be denied to OCI because the sale is to an affiliated person pursuant to paragraph 40(3.3) of the Income Tax Act. When the property is sold by RealCo to a third party (or RealCo and OCI come to be no longer affiliated), OCI will be entitled to claim the loss.

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The entire amount of this sale may be completed for a promissory note; there is no need to take back any share consideration.

Deadline

Please note that these forms must be filed no later than the earlier of the filing deadlines for the T2 Corporate Income Tax Return for OCI and RealCo. Because both OCI and RealCo have a December 31 taxation year end, the forms will be due on June 30, 2016.

Late filing of the election form is permitted but is subject to a penalty.

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Assessment Opportunity #6

The candidate discusses the income tax filing positions for the first two years of RealCo.

The candidate demonstrates competence in Taxation

CPA Map Competencies:
6.1.2 – Determines taxes payable for a corporation in routine situations (Core – Level B; moves to Level A in Taxation Elective)

Several income tax filing positions require further explanation.

Financing Fees – ITA 20(1)(e)

Fees incurred in the course of borrowing money are only deductible at a rate of 20% per annum (pro-rated for short taxation years). Therefore, the full amount of the $1,314 loan fee will not be deductible when incurred, but instead will be deductible over a 5-year period. The claim in the first year will be pro-rated for the shortened fiscal year. As a result, the amortization of the financing fee will need to be added back and the claim in accordance with ITA 20(1)(e) deducted (which will lead to no net impact on taxable income).

Capitalized Property Tax

Deductions for property tax on vacant land are restricted pursuant to subsection 18(2) of the Income Tax Act. Property tax on vacant land may only be deductible if the land is used in the course of a business carried on in the particular year by the taxpayer, other than for real estate development.

Property II would represent either capital property to be sold or land to be developed for the purposes of renting. In both cases, subsection 18(2) applies and denies deductions for property tax expense on this land. Therefore, the property tax on Property II should be added back when computing the taxable income of RealCo. This will be added to the adjusted cost base of the land. Property taxes on the remaining properties will continue to be deductible as an expense of doing business.

Tenant Inducements Paid

An expenditure is only deductible under subsection 9(1) of the Income Tax Act if it is incurred for the purposes of earning income and if it is not a capital expenditure, under paragraphs 18(1)(a) and (b) of the Income Tax Act. We would take the view that the payment of a tenant inducement is a current expense under ITA 9(1), since it is required for securing a current tenant and an income stream. This is consistent with various court cases.

There is an argument that the expenditure may be on account of capital, since it may be seen as providing a long-term benefit. This is supported by the accounting treatment of the tenant inducement. However, the better view is that it is deductible when incurred, since it forms part of the well-established business practices for a real estate company in obtaining tenants and securing a regular stream of income.

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Assessment Opportunity #7

The candidate calculates the maximum capital cost allowance claim for the first two years of RealCo.

The candidate demonstrates competence in Taxation

CPA Map Competencies:
6.1.1 – Assesses a corporate entity's general tax issues (Core – Level B; moves to Level A in Taxation Elective)
6.1.2 – Determines taxes payable for a corporation in routine situations (Core – Level B; moves to Level A in Taxation Elective)

Capital Cost Allowance

A taxpayer can claim a maximum deduction under paragraph 20(1)(a) of the Income Tax Act for capital cost allowance (CCA) based on the regulations prescribing the calculation, depending on the assets that it owns during the year. CCA is calculated on a class (pool) basis as opposed to by individual assets. For most properties, this calculation is determined on a declining balance basis.

Pursuant to Appendix IV, the maximum CCA that RealCo may claim is as follows for the following two years:

- 2015 (Year 1) – $549
- 2016 (Year 2) – $2,165

These numbers are incorporated in the tax calculation performed above.

Two of the elements of the calculation require further explanation.

Pro-rated CCA

You have indicated that you would like the new corporate structure in place effective October 1 but that the subsidiaries will need to retain a December 31 year end. Therefore, I have assumed that the taxation year for 2015 will be from October 1 to December 31 (92 days). CCA has been pro-rated for the short taxation year. The requirement to pro-rate CCA is outlined under Regulation 1100(3).

Half-Year Rule

When property is acquired, it is normally subject to the half-year rule, which is outlined in Regulation 1100(2). This rule requires that the amount of undepreciated capital cost (UCC) for the purposes of calculating the CCA claim for the pool is calculated as being equal to the following:

Opening UCC + Additions − [(Additions − Proceeds) × 50%]

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Assuming no proceeds of disposition, this has the effect of allowing a CCA claim for only one-half of the additions in the year of acquisition (or, viewed alternatively, the full addition at one-half of the CCA rate).

The half-year rule is examined in more detail when the depreciable property is acquired from a person not dealing at arm's length. When the property is acquired from a non-arm's length person, pursuant to Regulation 1100(2.2)(e), the ownership period of the related person may be considered for the purposes of determining if the half-year rule applies. Therefore, RealCo will not be subject to the half-year rule in 2015 because all of the assets have been owned for at least 365 days by OCI. RealCo and OCI are not dealing at arm's length because OCI controls RealCo.

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APPENDIX I

PROPERTY FAIR MARKET VALUES
(in thousands of dollars)

	Total FMV	**Building**	**Land (Note 1)**
Property I (Note 2)	60,000	42,000	18,000
Property II	8,000	0	8,000
Property III (Note 3)	17,000	11,900	5,100
Property IV (Note 4)	11,175	7,175	4,000
	96,175	61,075	35,100

Notes

1. 30% of the total property value for Property I and Property III.
2. \$3,900 NOI ÷ 6.5% capitalization rate
3. \$850 NOI ÷ 5.0% capitalization rate
4. As valued by the real estate professional

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APPENDIX II

LAND TRANSFER TAX AND FINANCING
(in thousands of dollars)

	Land Transfer Tax	Maximum Loan
Property I (Note 1)	1,195.50	42,000
Property II (Note 2)	200.00	4,000
Property III (Note 3)	425.00	11,900
Property II-C (Note 4)	167.63	7,823
	1,988.13	65,723
Deduct land transfer tax		1,988
Deduct financing fee (2%)		1,314
Funds available from financing		62,421

Notes

1. $60,000 FMV less $400 ($350 + $50) × 2% + ($350 × 1%) = $1,195.50
   $60,000 FMV × 70% = $42,000

2. $8,000 FMV × 2.50% land transfer tax = $200.00
   $8,000 FMV × 50% for undeveloped land property = $4,000

3. $17,000 FMV × 2.50% land transfer tax = $425.00
   $17,000 FMV × 70% = $11,900

4. $11,175 FMV × 1.50% land transfer tax = $167.63
   $11,175 FMV × 70% = $7,823

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APPENDIX III

DRAFT T2057 TAX ELECTION FORM
(in thousands of dollars)

		Elected Amount Limits					
Note	**Property**	**FMV**	**A (Agreed Minimum)**	**Agreed Amount**	**Amount to Report**	**Consideration Received (Note 5)**	**FMV**
	I – Land	18,000	16,200	16,200	0		
1, 2	I – Building Cl 1	42,000	38,000	38,000	0		
	III – Land	5,100	3,000	3,000	0		
1, 2	III – Building	11,900	8,000	8,000			
3						Promissory note	65,200
4						1 common share	11,800
	Total	**77,000**		**65,200**			**77,000**

Notes

1. The minimum elected amount for each property will be equal to its cost. This is because the UCC minimum is calculated on a class basis. It is expected that the aggregate Class 1 UCC balance will be sufficient to avoid any minimums due to the presence of properties that are not being sold. However, this will need to be verified on the final property transferred.

2. Properties are disposed of in a designated order by the taxpayer; we will assume that the order is the sequential manner outlined on the election. The remaining UCC in Class 1 prior to disposing of Property IV is equal to $48,500 ($94,500 UCC − $38,000 − $8,000). This proves that the minimum elected amount and agreed amount is still equal to cost. Furthermore, there is sufficient UCC remaining for the sale of Property IV on a taxable basis, as described above.

3. A promissory note will be equal to the aggregate agreed amount.

4. The common share will have a fair market value of $11,800 and paid-up capital and ACB of nil.

5. This could be allocated on an item-by-item basis; the only requirement is that the note should not be taken in excess of the elected amount.

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APPENDIX IV

CCA CLAIM FOR THE NEXT TWO YEARS
(in thousands of dollars)

	Year 1	Year 2	
Class 1			
Opening	0	53,878	
Additions (Note 1)	54,427	481	
CCA (Note 2)	(549)	(2,165)	
Closing	53,878	52,194	

Conclusion

The maximum allowable CCA claim for each of the two years is as calculated above.

Notes

1. Year 1 – Agreed amount of Class 1 per draft T2057 of $46,000 plus $7,175 fair market value of building for Property IV that was not sold under section 85, plus land transfer tax incurred on the transfer of $1,252 (70% × [1,988.13 − 200])
   Year 2 – $96,175 FMV of properties × 0.5% minimum incremental annual property improvements per financing agreement

2. Year 1 – $549 ($54,427 × 4% × [92 ÷ 365])
   Year 2 – $2,165 ([53,878 + ½ × 481] × 4%)

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